Local government in Scotland
Supplement 2

Financial overview 2017/18

Scottish Local Government Pension Scheme

ACCOUNTS COMMISSION

Prepared by Audit Scotland
December 2018

The Accounts Commission

The Accounts Commission is the public spending watchdog for local government. We hold councils in Scotland to account and help them improve. We operate impartially and independently of councils and of the Scottish Government, and we meet and report in public.

We expect councils to achieve the highest standards of governance and financial stewardship, and value for money in how they use their resources and provide their services.

Our work includes:

- securing and acting upon the external audit of Scotland's councils and various joint boards and committees
- assessing the performance of councils in relation to Best Value and community planning
- carrying out national performance audits to help councils improve their services
- requiring councils to publish information to help the public assess their performance.

You can find out more about the work of the Accounts Commission on our website: www.audit-scotland.gov.uk/about-us/accounts-commission

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. We help the Auditor General for Scotland and the Accounts Commission check that organisations spending public money use it properly, efficiently and effectively.

Contents

Summary

Key messages

1. **The triennial funding valuation at 31 March 2017 showed improved funding positions for most funds, with a number showing funding levels of more than 100 per cent.**
2. **Employer contribution rates have largely remained the same or gone up, reflecting lower expectations around investment returns going forward.**
3. **Membership of the Scottish Local Government Pension Scheme (SLGPS) continues to grow but total benefits and administration costs have exceeded contribution income in the last two years.**
4. **Investment returns were positive in 2017/18 although short-term performance was variable across funds.**
5. **Pension funds have been reviewing their investment strategies due to factors such as the maturity of the pension fund, the overall funding position and investment advisers' outlook on markets (particularly in connection with EU withdrawal).**
6. **Some pension funds have introduced Investment Panels. Lothian, Falkirk and Fife pension funds are collaborating on investment advice.**
7. **There have been many changes affecting the administration of schemes including new regulations, staffing pressures and new systems.**
8. **The Scottish Scheme Advisory Board is currently consulting on the future structure of the SLGPS.**

About this report

1. This supplement accompanies our Local government in Scotland: Financial overview 2017/18 and provides an overview of the Scottish Local Government Pension Scheme (SLGPS). We have drawn on the annual accounts of the pension funds administered by councils and on the reports of their appointed auditors. There are 11 main funds in Scotland, but also a number of other funds - often "Transport Funds" - administered by councils. Unless otherwise identified, our comments refer to the main 11 funds. The 11 main funds cover 32 local authorities and around 500 other employers.
2. This report identifies some of the major issues that pension funds had to deal with in 2017/18.

Funding

Triennial valuations

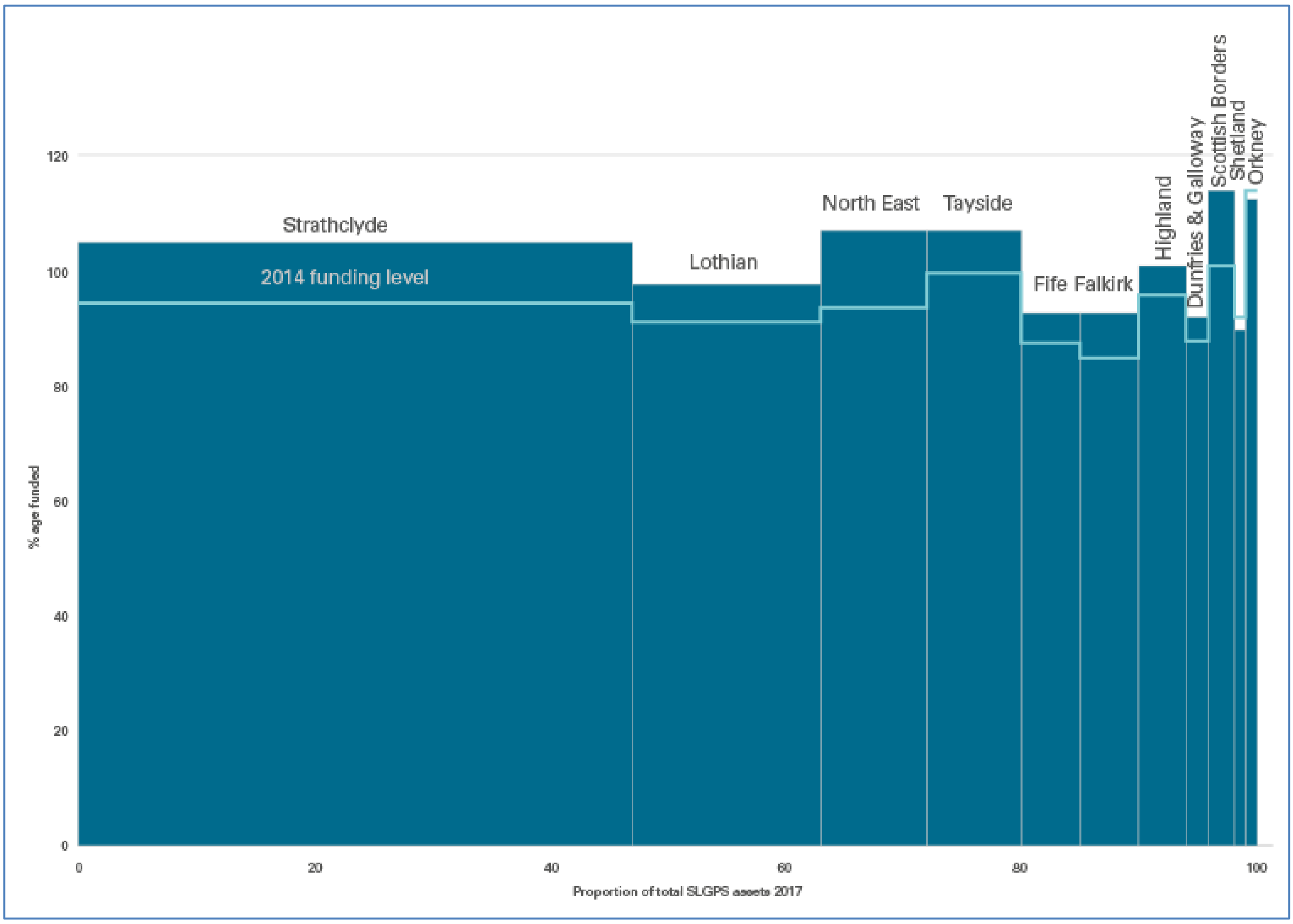
The triennial funding valuation at 31 March 2017 showed improved funding positions for most funds with a number showing funding levels more than 100 per cent.

3. The results of the triennial funding valuation, undertaken at 31 March 2017, were reported in 2017/18. In overall terms, SLGPS assets exceeded the liabilities to be met by the scheme. Assets of the main funds had increased to £42 billion while the estimated value of liabilities increased to around £41 billion. However, not all pension funds were fully funded as shown in Exhibit 1.

Exhibit 1

SLGPS funding levels 2014 and 2017

Strathclyde accounts for 47 per cent of SLGPS assets at 31 March 2017 and had a funding level of 105 per cent. In most cases funding levels improved with six funds in excess of 100 per cent.



Source: Pension fund annual reports and accounts

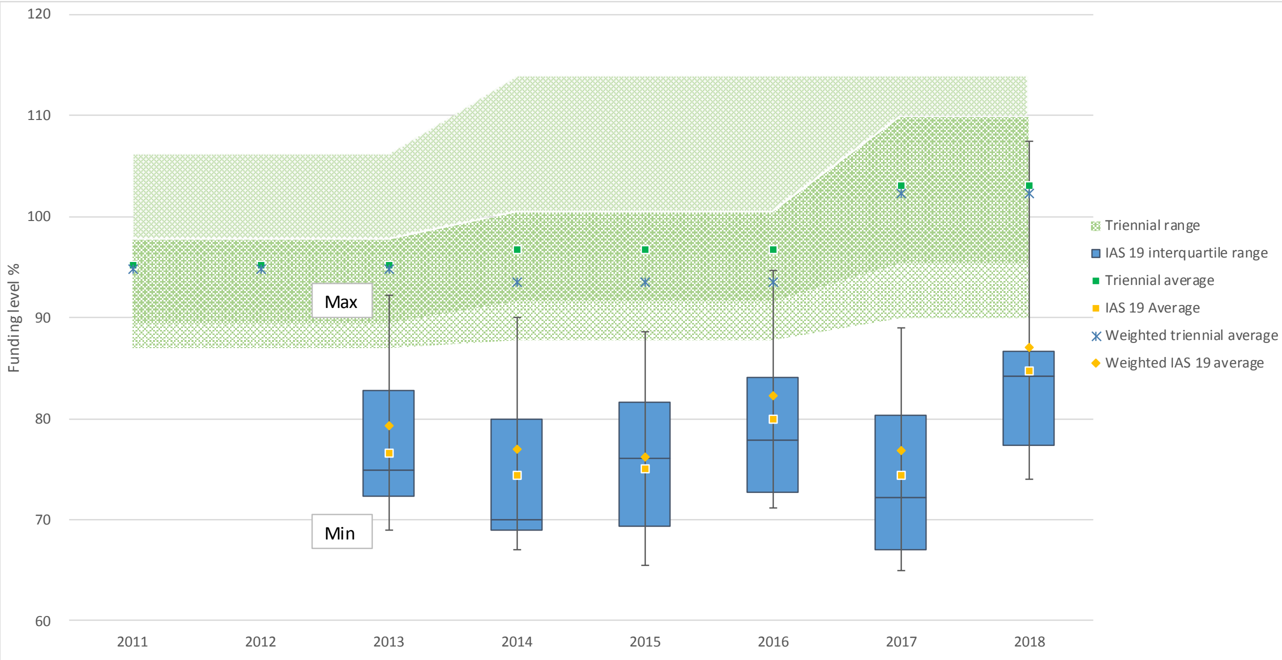
4. The 2017 funding positions represented an improvement on 2014 for all funds, except Orkney and Shetland. These improved funding positions arise because of increased asset values.

5. Triennial valuations at 31 March 2017 provide one basis for assessing the overall position of funds (funding basis). Actuaries prepare a valuation at 31 March each year, on an accounting basis (IAS19 basis). This approach uses a lower discount rate for long-term liabilities and this tends to produce a more cautious result, as can be seen in Exhibit 2.

Exhibit 2

Valuation history of SLGPS funds (triennial and IAS 19)

IAS19 annual valuations tend to be more cautious than the triennial funding valuations.



Source: Pension fund annual reports and accounts 2010/11 to 2017/18

Employer contributions have tended to stay the same following the triennial valuation

6. For most employers, contribution rates have remained the same even where pension funding levels exceed 100 per cent. This reflects lower expectations for investment returns going forward:

- at Strathclyde, North East Scotland, Tayside, Highland, Shetland, Scottish Borders, Fife, and Dumfries and Galloway pension funds contribution rates have remained stable
- rates in Lothian and Falkirk pension funds have increased
- Orkney rates have reduced.

Membership and cashflow

Membership of the SLGPS continues to grow but benefits and administration costs have exceeded contribution income in the last two years

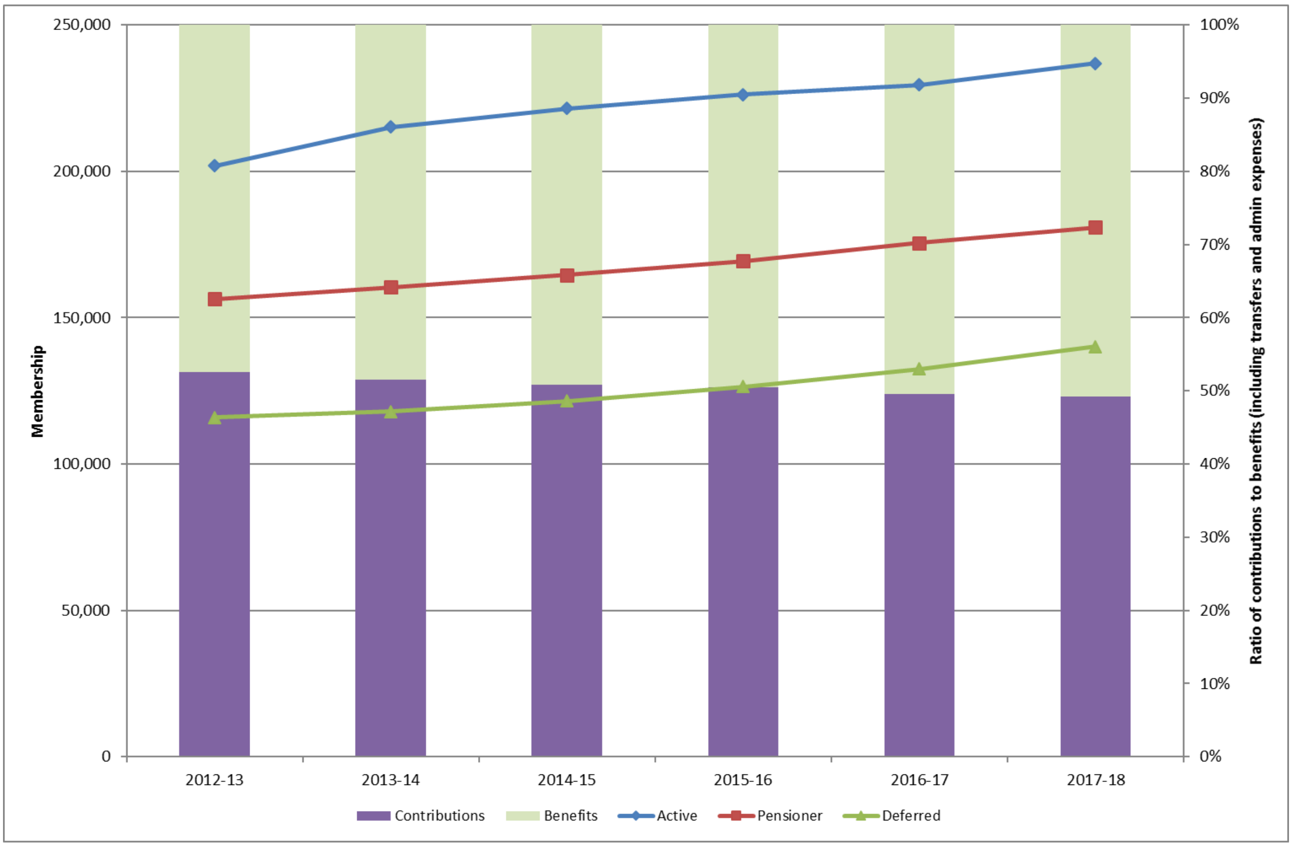
7. Exhibit 3 shows that the numbers of both active employee members and pensioner members of the SLGPS have been increasing in recent years. This is largely a result of auto enrolment and employer severance schemes. Active membership increased by 7,300 or three per cent in

2017/18 and pensioner numbers went up by 5,300, also an increase of three per cent. Across the SLGPS, total contribution income is now less than the benefits paid (negative cashflow from dealing with members). Five funds now have negative cashflows. As funds mature, an element of pension payments are being made from investment returns, rather than being met from ongoing contributions from active members. It's important that funds manage the cashflow implications of this.

Exhibit 3

SLGPS membership, contributions and benefits 2013 to 2018

Membership has been increasing. Costs are greater than contributions received.



Source: Pensions fund annual reports and accounts

8. The proportion of active members compared to pensioner members is higher than it was five years ago. Despite there being greater numbers of active members, this has not reversed the trend of negative cashflow from dealing with members. This is plausible as many of these new active members were added through auto enrolment and are lower paid employees with lower contributions relative to pensions in payment.

Investment performance and strategy

Investment returns

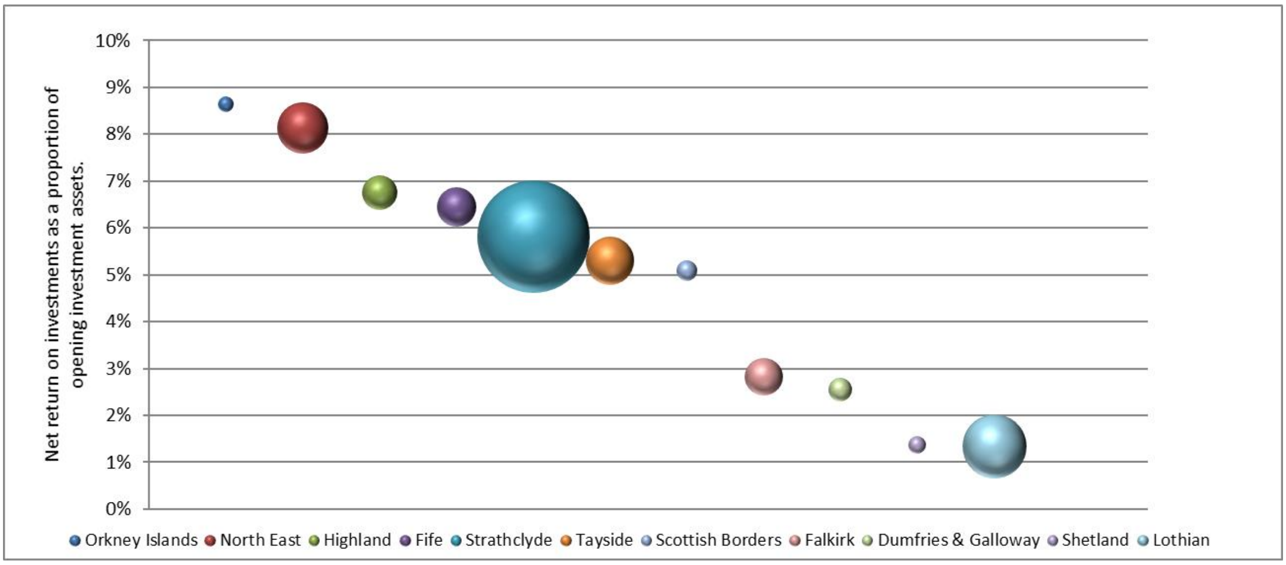
Annual investment returns were positive in 2017/18 although performance was variable

9. Investment returns remained positive in 2017/18 despite increased volatility and decline in the final quarter of the year. The weighted average return on investments was around five per cent, a significant decrease compared to 18 per cent in 2016/17. This reflects the general performance of markets between the two years. The performance and relative size of each pension fund is shown in Exhibit 4.

Exhibit 4

Annual investment returns and fund size 2017/18

The weighted average investment return for the SLPGS was just over 5 per cent in 2017/18.



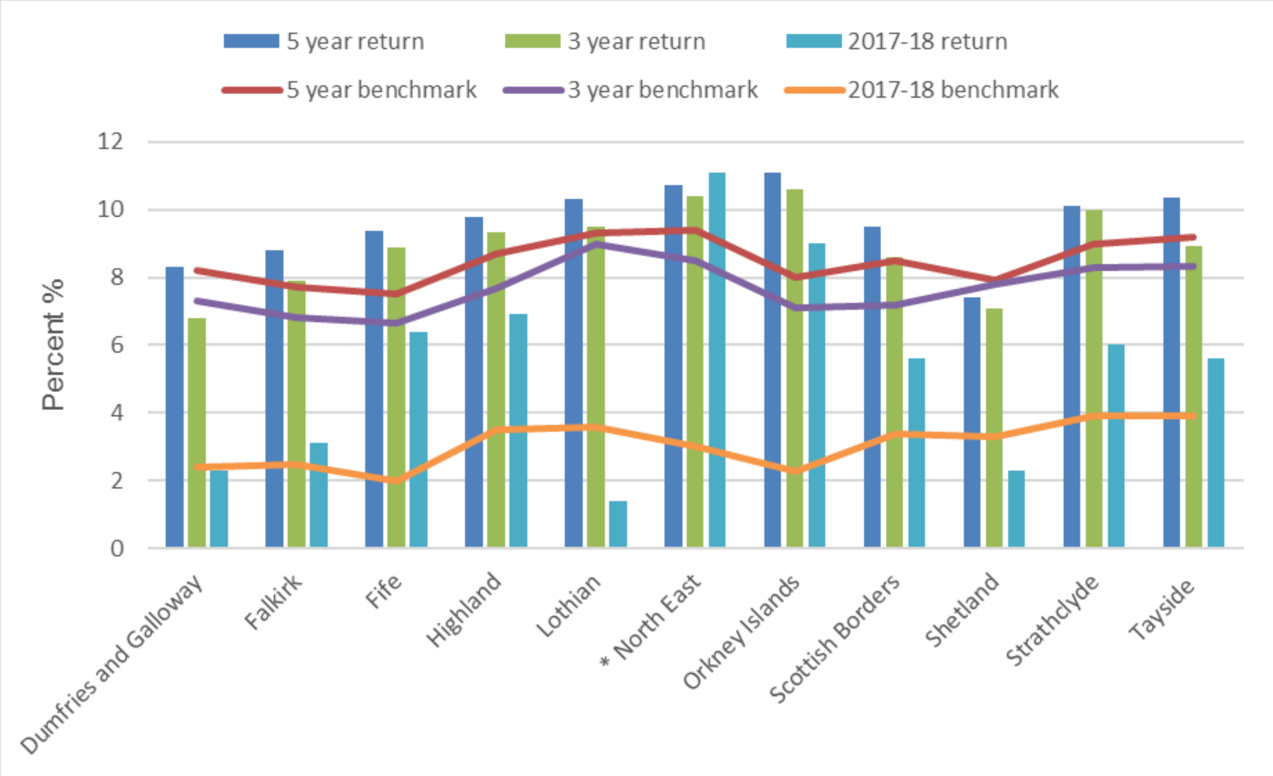
Source: Pension fund annual reports and accounts

10. Variability of investment performance between pension funds can reflect differences in the nature of assets which each fund holds, the way in which they are managed and the related risks. Another way of assessing the returns in each fund is to consider how the fund has compared against its benchmarks over 1 year, 3 years and 5 years. The benchmarks are set locally to reflect the nature of each investment mandate and the proportion of different mandates in the portfolio. Performance against each of the 11 funds benchmarks is shown in Exhibit 5.

Exhibit 5

Pensions fund performance against their benchmarks 2017/18

Investment returns for most funds were above benchmark over the 5 years to 31 March 2018.



** North East Scotland pension fund figures are on a gross basis*

Source: Pension fund annual reports and accounts

11. Exhibit 5 identifies, for example, that in Lothian pension fund the return on investments in 2017/18 was 1.4 per cent, which was behind the benchmark of 3.6 per cent, however, the performance over the five and ten-year period to 31 March 2018 exceeded the benchmark by an average of 1.1 percentage points.

Investment strategies

Investment strategies are set by each fund and indicate the nature and extent of investments the fund should hold

12. Investment strategies are set locally by each of the pension funds, although they have to comply with a common regulatory framework. Pension funds appoint independent professional advisors to help them with their investment strategies. Some funds use external firms for direct investment advice to pensions committees and boards. Some funds have investment panels that employ specialist advisers before recommendations are made to the pensions committee/boards. In 2017/18, Fife Pension Fund joined with Lothian and Falkirk in a collaborative arrangement for investment governance which includes a joint investment strategy panel advising all of these funds.

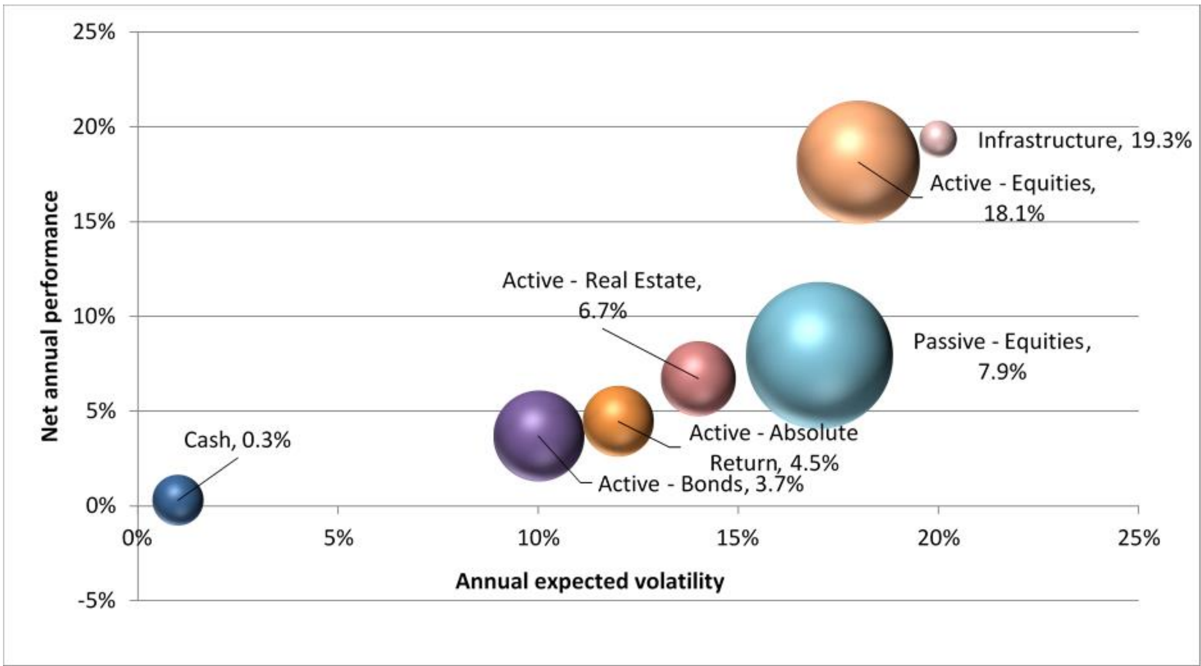
13. Investment strategies should take account of the current funding and cash-flow position of the fund and reflect the investment outlook to achieve the returns necessary to maintain employer contributions. Seeking higher returns typically exposes pension funds to higher risk.

14. Exhibit 6 demonstrates the different investments and their relative size and returns at Fife pension fund. The fund has 11 investment mandates, managed by nine fund managers. Cash balances form a relatively small working capital balance and achieve very low returns. Infrastructure investments earned high returns but are relatively modest in size. Equities - both active and passive mandates - form the majority of the invested assets. Passive equity investments earned much lower rates of return than active mandates, but they also have lower fees. Investments that earned the higher rates of return were also considered to be the most volatile (riskier).

Exhibit 6

Asset allocations, performance and volatility – Fife Pension Fund as at 31 March 2018

Passive equities were the largest category of investment delivering relatively high returns but with a relatively high exposure to market volatility.



Source: Fife pension fund annual audit report

Pension funds have been reviewing their investment strategies

15. Some funds identified that they have reviewed their investment strategies. This is due to factors such as the maturity of the pension fund, the overall funding position and investment advisers' outlook on markets (particularly in connection with EU withdrawal):

- One fund identified that "the primary consideration was the impact of the EU withdrawal on movement in investments and risk".

- At Scottish Borders Pension Fund, the auditor noted that the fund is ".. to diversify away from equity assets into income generating inflation-linked assets that are more resilient to the volatility of the equities markets. Increasing investment in infrastructure, which is not as tied to global events… management are aware of the currency fluctuation risk and are working with their investment consultant to determine ways to mitigate that risk".
- Strathclyde Pension Fund noted that it had begun "the implementation of a revised strategic target model… to hold less equity and move to more short-term and long-term enhanced yield assets… such as UK and overseas property. The fund has reduced equity holdings by £2 billion from 68.6 per cent of assets… to 56.7 per cent… to de-risk the investment portfolio at a time where there is some increasing uncertainty in global markets."

16. Funds are also reporting that the actual investment portfolio is not consistent with their investment strategies. Increases in the value of equities has meant that some funds are holding more of their total value in equities ('overweight in equities') compared to their investment strategies:
    - Fife Pension Fund auditor reported that 62 per cent of the fund's investments are in equities, that the fund has not rebalanced its mandates since last year, remains overweight in equities (against a target of 55 per cent) and underweight in bonds.
    - The auditor of Falkirk Pension Fund identified that "the future projected strategic allocation of investments, outlined in the fund's statement of investment principles, shows a significant divestment from the current allocation".

Investment costs

Investment costs are becoming more transparent

17. In recent years there has been increased interest in the investment costs incurred by the SLGPS, with a drive for more transparency from investment managers about the fees and charges they make. Ensuring that investment management expenses are reasonable can be one way for pension funds to increase returns without increasing risk.

18. However, full transparency is still to be achieved. The auditor at Tayside Pension Fund identifies that "the fund has incurred £1.7 million of investment transaction costs, which it has capitalised as part of the cost of the investments rather than including within investment management expenses."

19. Investment management expenses have increased in 2017/18. The main reason for this increase in expense is the growth in equity values, but there are other reasons:
    - Fife Pension Fund reported a high initial cost of the infrastructure mandate, which carries out private equity-type investments. It levied performance fees of £1.7 million and made two new investments with one-off fees of £1.6 million.
    - Scottish Borders Pension Fund auditor noted that "there has been significant... investment management expenses of… £8.2 million. This is largely because of one-off

transaction costs associated with investment in long-lease property, which is seen as a key part of the investment strategy. (Their adviser was)... confident this cost will be recouped through investment performance."

Governance

Committees and boards

Pension committees and pension boards oversee the funds

20. From 1 April 2015 all pension funds were required to introduce local pension boards in line with the Public Service Pensions Act 2013. This is the third year of operation of the Pensions Board. The Pensions Board usually meet concurrently with the Pensions Committee. The remit of the Pensions Board is to support the Pension Committee to comply with regulations and the requirements of the Pensions Regulator. In some councils, the responsibility for pension fund matters is split between committees.

21. Division of pension responsibilities to two committees may restrict the information available to some responsible for governance. In Fife, the oversight of pension fund governance and risk management remain in the remit of Fife Council's Standards and Audit Committee. Weaknesses in pension fund governance and management arrangements are reported to the Standards and Audit Committee, but not routinely to the Superannuation Fund and Pensions Sub-Committee or the Pensions Board. The two committees share the same convenor, so this helps to ensure that key issues are brought to the attention of both.

Some pension funds have introduced investment panels

22. To assist and advise the pension committee and board on investments strategy and performance, some pension funds have introduced advisory panels. This helps officers call on wider investment knowledge and expertise. It also introduces a governance process which sits between the investment advisor and the committee, reducing the burden on committees and on council officers to consider the detail of investment proposals/decisions. Strathclyde Pension Fund's Investment Advisory Panel (the IAP) comprises "investment officers from the fund, representatives from Hymans Robertson (as the fund's actuary and investment consultant). The panel also includes three independent expert advisors. The IAP supports the Pension Fund Committee and is responsible for developing investment strategy and monitoring investment performance."

23. At Lothian Pension Fund, the pensions committee has delegated responsibility for investment strategy to the executive director of resource who takes advice from an Investment Strategy Panel made up of the chief executive of the fund, chief investment officer and two external independent investment consultants.

Collaboration

Lothian, Falkirk and Fife pension funds are collaborating on investment advice

24. Lothian, Falkirk and Fife pension funds have set up a joint working arrangement which includes a joint Investment Strategy Panel. The role of this panel will be to advise the chief

financial officers of each administering authority on the implementation of investment strategy. Over the last year, Lothian collaborated with Falkirk on seven infrastructure investments.

25. The Scottish Borders Pension Fund also noted that it "continues to invest in other assets classes such as long-lease property, private credit and infrastructure, by partnering with Lothian Pension Fund."

Other issues

In 2017/18 Tayside undertook a repatriation exercise

26. As noted in the introduction to this report, apart from the main 11 funds, there are a few other funds managed by councils. These include Lothian Buses Pension Fund and Scottish Homes Pension Fund, for example. These funds are distinct from the main funds. They are often closed to new members and, as mature funds, have funding and investment strategies that are very different to the main funds.

27. At Tayside Pension Fund, following legal, actuarial and investment opinion and full employer consultation, the Pensions Sub-committee approved the repatriation of assets and liabilities of the Tayside Transport Fund back to the main fund. This was intended to provide the single employer, Xplore Dundee, with a guaranteed future contribution rate and to provide administrative efficiencies and value for money. The expectation is that repatriation would reduce custodial and actuarial fees, investment and management costs. The repatriation took place on 30 June 2018 and resulted in the transfer of £71 million of transport fund net asset values into the main fund which had a net asset valuation of £3.5 billion at that date.

Cessations can lead to additional financial pressures

28. Auditors have been reporting that a number of employers have indicated they want to leave, or have left, pension funds in 2017-18. These cessation events can lead to additional contributions from those employers and sometimes decisions on the recoverability of cessation debts. Cessation payments at Lothian Pension Fund were £1.4 million in 2017/18 and it has long-term debtors of £1.5 million associated with cessation.

29. At 31 March 2018, the North East Pension Fund recognised that there were three employers who had exited from the Fund where payment of the termination fee may not be recovered in full.

There were some reported issues with employer returns

30. Employers are required to submit year-end contribution returns and compliance returns usually by the May after each financial year-end. This is an important control over the accuracy of pension contributions received and recorded in the pensions systems and is of increased importance following the introduction of Career Average Revalued Earnings (CARE) schemes: as the member benefit statement requires actual salary data from all employers.

31. All year-end contribution returns relating to 2017/18 have been received by funds. One auditor identified issues with the lateness of contribution returns, with more auditors identifying issues with employer compliance returns.

Administration

Changes affecting funds

There have been many changes affecting the administration of schemes

32. SLGPS pension funds have faced significant administration challenges in recent years. We have identified the effect of auto-enrolment and the increase in membership at paragraph 7, but there have been other changes.

33. Revised Local Government Pension Scheme regulations came into effect on 1 June 2018. The changes to the regulations aim to consolidate amendments since April 2015 and include:

- LGPS members can elect to take early payment of their pension from age 55, with an actuarial reduction. They will not require consent from their employing body.
- There is increased flexibility for administering authorities when employers exit the pension scheme. Exit credit can be provided to exiting employers if appropriate.
- There are changes to additional voluntary contributions following the introduction of freedom and choice in pensions by the UK Government, which permits payment from age 55 as a lump sum.

34. New data regulations (GDPR) covering data protection came into force on 25 May 2018. Auditors reported that pension funds' preparations for this had been completed as planned.

35. In May 2017, several health boards across NHS Scotland were affected by the Wannacry global ransomware attack. In response to this, the Scottish Government launched 'A Cyber Resilience Strategy for Scotland: Public Sector Action Plan, 2017/18'. The action plan outlines various requirements that public bodies should take forward. It includes an action for public bodies to achieve a Cyber Essentials Plus certification by the end of October 2018. There is a need to consider whether the pensions' systems supplier meets Cyber Essentials standards. We recommend the fund encourages its suppliers to adopt the Cyber Essentials standard.

36. The auditor at Fife Pension Fund noted the loss of five experienced staff members from the administration team and issues with reconciliations and recording of non-routine transactions. Borders Council implemented a new financial system, Business World, in April 2017 and undertook a subsequent restructuring of the finance function. The auditor noted that "this has placed a significant burden on key team members at certain times."

Outlook

SLGPS structural review

The Scottish Scheme Advisory Board (SSAB) is currently consulting on the future structure of the SLGPS

37. In 2017 the SSAB reported to the Scottish Minister on options for the future structure of the SLGPS. The report referred to the potential economies of scale and cost savings available in relation to the administration and investment activity of pension funds, highlighting the likely impact of different options on local governance and oversight. The report included four options for consideration:
    - retain the current structure with 11 funds
    - promote cooperation in investing and administration between the 11 funds
    - pool investments between 11 funds
    - merge the 11 funds into one or more funds.

38. Early in 2018 the Scottish Minister requested that the SSAB consult more widely on these options and in June 2018 a consultation was launched, with a decision on the future course of action in 2019.

Local government in Scotland
Supplement 2

Financial overview 2017/18

Scottish Local Government Pension Scheme

This report is available in PDF and RTF formats, along with a podcast summary at:
www.audit-scotland.gov.uk

If you require this publication in an alternative format and/or language, please contact us to discuss your needs: 0131 625 1500 or **info@audit-scotland.gov.uk**

For the latest news, reports and updates, follow us on:

Audit Scotland, 4th Floor, 102 West Port, Edinburgh EH3 9DN
T: 0131 625 1500 E: **info@audit-scotland.gov.uk**
www.audit-scotland.gov.uk